Agenda Date: December 14, 2005
Item Number:

Docket: UG-051651

Company Name: Cascade Natural Gas Corporation

Staff: Joelle Steward, Regulatory Analyst
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Recommendation:

Issue a complaint and order suspending the filing in Docket UG-051651, and set the matter for hearing.

Background:

On October 31, 2005, Cascade Natural Gas (Cascade or Company) filed, in this docket, a tariff revision adding Rule 21, Conservation Alliance Plan Mechanism, and an Application for an Order Requesting Authorization for Deferred Accounting Treatment. The Conservation Alliance Plan is a decoupling mechanism using a revenue-per-customer approach, which de-couples revenues from sales, and re-couples revenue to the number of customers. Specifically, it consists of two deferral accounts. One deferral tracks changes in margin due to changes in consumption (e.g., conservation). The second deferral tracks changes in margin due to variances from normal weather. Both deferrals use a baseline of margin per customer from the Company's last general rate case in 1995, Docket UG-951415. The proposed mechanism only applies to Residential General Service Rate Schedule 503 and Commercial General Service Rate Schedule 504.

The filing also includes an Earnings Sharing Mechanism that will return a portion of earnings to ratepayers when the Company's return on equity exceeds a threshold of 13.25 percent. In the filing, the Company also commits to expand its customer information program and demand-side management activities and provide $1 million to community service agencies to fund low-income conservation and bill assistance programs. The Company proposes that the mechanism be approved for a five-year trial period, from December 15, 2005, to October 31, 2010, with renewal subject to a general rate case review.

Discussion:

Decoupling is a regulatory mechanism that separates a utility's profits from sales, thereby removing a utility's disincentive to promote energy efficiency and allowing the utility to pursue least-cost resource strategies. A decoupling mechanism gives a utility recovery of an agreed upon level of revenue independently from sales, through annual adjustments. Interest in decoupling has re-emerged in recent years as the industry has returned to placing emphasis on integrated resource planning, due to a halt in the trend toward industry restructuring.

The Commission recently concluded a rulemaking reviewing natural gas decoupling, in Docket UG-050369. After reviewing written comments from stakeholders and participating in a workshop, the Commission chose to withdraw the rulemaking, stating:

> The Commission believes that the wide variety of alternative approaches to decoupling make it efficient to address these issues in the context of specific utility proposals *included in general rate case filings* rather than through a generic rulemaking.[1] [Emphasis added.]

The Commission further notes in explaining its decision to withdraw the rulemaking:

> Any such [decoupling] proposal would necessarily be designed to fit with the utility's particular circumstances and needs to be accompanied by sufficient financial information to allow the Commission to thoroughly analyze its implications for customers and the utility. The Commission presumes that the most efficient way to fully assess these effects would be *through a general rate case filing*.[2] [Emphasis added.]

This filing by the Company lacks "sufficient financial information" and relies on an outdated baseline to establish a revenue requirement. A decoupling proposal from Cascade needs to be assessed within a general rate case proceeding in order to ensure the mechanism is in the best interests of customers as well as the company.

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[1] Notice of Withdrawal of Rulemaking, October 17, 2005, Docket UG-050369.
[2] Summary, Analysis of Comments and Decision to Close Docket without Action, attachment to Notice of Withdrawal of Rulemaking, October 17, 2005, Docket UG-050369, page 10.

Below, we discuss our specific concerns with the filing and we identify unresolved questions that should be considered before allowing Cascade to implement a decoupling mechanism.

Staff's Specific Concerns with Cascade's Decoupling Filing

1. *The use of a baseline from 10 years ago compensates the Company for historical changes rather than improving incentives for future efforts.*

Staff's most significant concern with the proposed mechanism is that it will set margin recovery to a 10-year old baseline of per-customer consumption. Cascade's customers have significantly reduced their per-customer consumption in the past 10 years, and the Company is now proposing that it be compensated for the resulting loss of margin revenues associated with that long-term decline in per-customer consumption.

The purpose of a decoupling mechanism should be to remove financial disincentives to future energy efficiency efforts, not to adjust rates for past changes in consumption levels. Cascade is proposing that it be compensated for past effects, few of which could be attributed to its own efforts. The result will be that even if Cascade makes no future efforts to increase energy efficiency, the decoupling mechanism will raise rates by $4 million to $6 million per year, under normal weather conditions. This rate increase will be based solely on the historical decline in consumption, with no evidence that the increase is needed to cover current costs.

Cascade describes, in its application, operational efficiencies and new business opportunities it has vigorously pursued to control costs and minimize the need for a rate increase. These efforts will likely have some effect on overall costs and their allocations between customer classes. Furthermore, these operational efficiencies and the addition of new customers[3] since the last rate case effectively constitute "found margins" that have compensated the Company in the interim period, offsetting any need for a general rate case. The Company's proposal ignores these "found margins" that should be captured in rates before authorizing new revenue recovery.

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[3] In its Application, the Company states that the residential customer count has increased 52 percent and the commercial customer count has increased 28 percent since its last rate case.

If the Commission approves the filing, and allows Cascade recovery of revenues established nearly 12 years ago, it may violate the cost-based principle of regulation by creating a potential mismatch between current costs and rates. A revenue requirement is based on a snapshot in time regarding revenues, expenses, rate base, customers, and usage. The proposed mechanism locks in the revenue (margin) per customer from the last rate case but costs have changed substantially.

Accordingly, we can not recommend that the rates to be established by the Commission will be "fair, just, reasonable, and sufficient." A general rate case is needed in order to update margins for each customer class. Any approved mechanism should then only be in place for a relatively short (no more than three years) period of time due to the mismatch of revenues and costs over time.

2. *The proposed mechanism shifts risk to customers with no compensation.*

A decoupling proposal redistributes risk to ratepayers and increases volatility in customer bills. These effects should be studied and considered for implications on the allowed return of equity set in a general rate case proceeding.

The proposed mechanism redistributes risk to ratepayers because it eliminates the existing variability in revenues due to fluctuations in temperature. Currently, rates are designed to recover an allowed revenue requirement under normalized weather conditions.[4] Gas companies earn more in cold winters and earn less in warm winters. The variability of revenue due to risks such as weather, prices, conservation and other factors is implicitly captured in the authorized rate of return. Cascade's proposal reduces its risk by shifting it to customers; this effect should be reflected in the rate of return, through a general rate case proceeding.

Volatility in customer rates will increase under this decoupling mechanism while Cascade's earnings will both increase and be much more stable. To provide an example of the potential impact of the increase in revenue, Staff prepared a simulation of the proposed mechanism, using data for the period ending September 30, 2004. The table below shows the simulated results for the deferral balance under three possible conditions. The deferral balances, shown in the

[4]The Company proposes to use the weather normalization methodology used in the last rate case. This methodology should not be used without careful examination, as is done in a rate case, in order to establish a reasonable base for the proposed deferrals.

table below, are all positive, resulting in revenue to the Company and surcharge deferral balances to customers. Staff's simulation also indicated that the Company's return of equity would have increased during this period by approximately 300 basis points under the "normal weather" scenario.

Conditions	Deferral Total	% Change to Margin Revenue		
		Total	Sch 503	Sch 504
Normal Weather	$4,177,081	11%	12%	9%
5% volume decrease (e.g. warmer weather)	$6,072,779	17%	18%	15%
5% volume increase (e.g., colder weather)	$2,281,383	6%	7%	4%

These scenarios show that the mechanism proposed by Cascade produces a substantial rate increase even if the company makes no effort to increase energy efficiency and even under a range of weather conditions. The mechanism increases both the level of Cascade's earnings and the stability of those earnings, but Cascade proposes no adjustment to its authorized rate of return.

3. *The Earnings Sharing Mechanism allows for excess profits.*

The Company proposes an earnings sharing mechanism that will return to customers one-third of all revenues over an earnings threshold of 13.25 percent return on equity. This threshold represents a return on equity of 10.25 percent, plus 300 basis points. By comparison, the most recent decision by the UTC established a return on equity 10.3 percent for Puget Sound Energy.[5]

The purpose of a decoupling mechanism should be to protect a company from a decrease in earnings due to greater energy efficiency, not to allow the company to increase its profits above a fair level. Staff is concerned that Cascade is seeking approval of a broad incentive mechanism in the guise of a decoupling mechanism.

This mechanism is modeled after the revenue sharing mechanism Cascade has in Oregon. Staff does not believe that it is reasonable to simply adopt another state's allowed return, absent a full financial assessment for Washington. Moreover, Staff has concerns that only one third of the over earnings would be shared. Even with sharing, the mechanism will allow Cascade to earn an

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[5] *WUTC v. Puget Sound Energy*, Docket No. UG-040640, *et al.*, Final Order at 26 (February 18, 2005).

excessive rate of return and will insulate it from an earnings complaint for five years. If a company is over earning, the Commission can issue a complaint and rates can be reduced to eliminate all of the excess revenues causing an over earnings situation.

Areas of Study Required to Implement Decoupling Mechanism for Cascade

The following are areas to be studied and questions to be considered in an adjudicated proceeding before a decoupling mechanism can be approved for Cascade.

- What is the current cost of providing service (i.e., operating expenses and return on investment)?
- What is the current cost of providing service to each customer class (i.e., cost of service study)?
- What are the implications for risk to investors and how or should this be reflected in the authorized return of equity?
- What is the appropriate methodology for weather normalization?
- Is the Company's line extension policy and assumptions within the policy keeping up with the costs of adding new customers?
- Should the basic charge be increased in order to recover more fixed costs, or are there other rate design options to be considered?
- Should other firm customer classes be included in a decoupling mechanism?
- How should we structure an earnings sharing mechanism?
- What is the appropriate time frame for a decoupling mechanism? Two years, three years, five years? Or put another way, over what period of time can we expect revenue-per-customer to reasonably reflect costs?
- What specific energy efficiency programs will the Company implement with a decoupling mechanism, and at what budget?

Conclusion

This mechanism will provide a windfall of revenues to the Company without any reconciliation of actual cost to serve customers or specifically identified benefits to customers, other than $1 million to low-income customers. In light of the statements made by the Commission in withdrawing the decoupling rulemaking, and due to our specific concerns with this proposal, we recommend that the Company withdraw this filing and seek a decoupling mechanism in a general rate case filing. While our formal recommendation, by necessity, is to suspend the filing, we do not believe a suspended proceeding would be productive for any party. Lastly, the $1 million contribution to low-income agencies the Company has offered need not be intertwined with decoupling. Low-income assistance can be implemented independently.

Recommendation:

If Cascade does not agree to withdraw the filing, then Staff recommends that the Commission issue a complaint and order suspending the filing in Docket UG-051651, and set the matter for hearing.